Internal Revenue Service

memorandum

CC:TL:Br2
WCWicker

date: JUL 15 1988

to: District Counsel, Los Angeles W:LA
Attn: Charles O. Cobb

from: Director, Tax Litigation Division CC:TL

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subject: [redacted]

This is in reply to your memorandum received in this office on May 4, 1988. Your memorandum requests technical assistance with respect to the issue stated below.

ISSUE

Whether [redacted] ([redacted]) is entitled to claim a loss of $[redacted] in its taxable year ended [redacted], in connection with a sale and leaseback of a department store used in the business of [redacted] ([redacted]), one of the consolidated subsidiaries of [redacted].

SUMMARY

The sales price received by [redacted] for the department store approximated its fair market value. The rental charged [redacted] for the store was equal to the fair rental value of the store as of the date the lease was entered into. The lessor, [redacted] ([redacted]), was entitled to all of the condemnation proceeds upon a complete taking of the store. The lease did not grant [redacted] any greater control over the store than that generally held by a tenant. Given these facts, the case law, discussed below, establishes that [redacted] was entitled to deduct the $[redacted] loss in its taxable year ended [redacted].

FACTS

[redacted] acquired [redacted] in [redacted].1/ [redacted] operated a [redacted] department store [redacted] in New York City. At the time of its acquisition by [redacted], it was endeavoring to open a second store in [redacted], New York. To accomplish this goal, it purchased a parcel of vacant land in

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1/ After the acquisition, [redacted] and [redacted] filed consolidated returns.

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a shopping area in [redacted] on [redacted]. The price paid for the land was $[redacted]. In addition to purchasing the land, [redacted] hired an architectural firm, [redacted], to prepare plans and specifications for the new [redacted] store to be constructed on the land. The plans and specifications, including drawings, were prepared by mid [redacted]. In [redacted], [redacted] entered into a contract with a general contractor, [redacted], for the construction of the store for a lump sum price of $[redacted]. Construction commenced in [redacted] with a targeted completion date and store opening scheduled for [redacted].

During late [redacted], [redacted] investigated various means of financing the new [redacted] store. It eventually concluded that a sale-leaseback was the most attractive arrangement.2/ On [redacted], [redacted] entered into a sale-leaseback transaction with [redacted].3/ The transaction consisted of a purchase by [redacted] of the [redacted] store property from [redacted] followed immediately by a leasing back of this property to [redacted]. Legal title to the store property was conveyed to [redacted] on [redacted].

The sale-leaseback transaction was embodied in a lease agreement executed by [redacted] and [redacted] as of [redacted]. Under this agreement, the purchase price to be paid by [redacted] for the store property was tied to the construction cost of the store. The maximum purchase price was set at $[redacted],4/ representing the sum of (a) $[redacted] which was the maximum permanent financing [redacted] could obtain for the construction costs of the store and (b) a required equity investment by [redacted] of [redacted] percent of the cost of the store property up to $[redacted]. As for the leaseback to [redacted], it was for an "interim term" during store construction and for a "[redacted]" of [redacted] years after construction was

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2/ [redacted] did not wish to tie up its finances in holding and owning real estate. Instead it preferred to use its limited capital for retail merchandising. This preference was consistent with its prior practice: a majority of its stores were leased rather than owned during the period in question.

3/ The transaction was arranged by a broker, [redacted].

4/ [redacted] was required to "reimburse" [redacted] for construction costs up to a ceiling amount of $[redacted].

completed.5/ Rent charged for the interim term was $[redacted]. Annual rent for the fixed-term was set at the sum of (a) [redacted] percent of the purchase price to be paid by [redacted] for the store property and (b) $[redacted]. In a supplemental lease agreement dated [redacted],6/ the purchase price for the store property was increased slightly to $[redacted]. Annual rent for the fixed term was set at $[redacted], representing [redacted] percent of the purchase price plus $[redacted]. The lease was strict net, with [redacted] responsible for repairs, taxes and insurance.

Financing for store construction was provided under a note purchase agreement entered into by [redacted], [redacted] and the [redacted] ([redacted]), as agent for itself and several other insurance companies. Under the note purchase agreement, [redacted] was required to provide interim financing, advancing to [redacted] the funds necessary to construct the store. In return for the advances, [redacted] was entitled to receive a series of promissory notes from [redacted] which [redacted] could then sell, at face, to [redacted] and the other insurance companies. Upon purchasing these notes, [redacted] and the other insurance companies were entitled to exchange the notes for long-term secured notes issued by [redacted].7/ The amount of the notes to be issued by [redacted] to [redacted] was tied to the construction cost of the store but could not exceed $[redacted].8/ The note purchase agreement provided that "[i]f the cost of the property less the equity investment [of [redacted]] exceeds $[redacted], such excess shall be deemed a payment by the interim lender [[redacted] on behalf of lessee [[redacted]] toward the cost of leasehold improvements". The issuance, sale and exchange of notes contemplated under the note purchase agreement was to occur in two closings: the first on [redacted] covering costs to that date, and the second upon completion of the store. The first closing occurred as scheduled and involved notes in the face amount of $[redacted]. The second closing occurred on

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5/ [redacted] had the option to extend the lease after the fixed term expired for up to [redacted] additional years.

6/ By this time, construction of the store had been completed. Construction costs far exceeded $[redacted] and were in the $[redacted] range.

7/ The long-term secured notes carried [redacted] percent interest and were due over a [redacted]-year period.

8/ The insurance companies were not willing to provide more than $[redacted] in permanent financing for the store.

[redacted] and involved notes in the amount of $[redacted] (i.e., the difference between $[redacted] and $[redacted]).

As of [redacted], it was estimated it would cost $[redacted] to build the store.9/ The actual cost of completing the store was much higher than this figure. During the course of construction, the general contractor presented [redacted] with over [redacted] change orders increasing price by almost $[redacted]. This huge overrun was attributable to several sources: problems in laying the foundation, changes demanded by the [redacted] Building Department, the scarcity of a number of structural materials requiring substitutions, overtime and out of sequence work authorized by [redacted] to make the scheduled opening date of [redacted] (the store opened in [redacted]), and many changes and improvements to the design of the store made during the course of construction (for example, both levels of the store were redesigned to add lobby areas and the flooring material was changed from terazzo to marble). Also significant were the extremely high prices being charged by subcontractors for change order work and labor troubles, problems which, according to several people involved in the construction, were not dealt with in an effective manner by the general contractor. [redacted], in response to the overruns, hired a construction consultant, [redacted]. The consultant reviewed the change orders and recommended that almost half the charges under the change orders be rejected on the ground that the charges were excessive or were for work within the scope of the original contract. The consultant negotiated the matter on behalf of [redacted]. It was settled at about the time the store was completed, the general contractor reducing its claim for payment from about $[redacted] to $[redacted]. This figure, added to the cost of the land, architect fees, etc., resulted in a basis in the store to [redacted] of $[redacted].

The sale to [redacted] closed on [redacted].10/ [redacted], on its return for the year ended [redacted], reported the sale as follows:

Sale proceeds	$[redacted]
Adjusted basis	[redacted]
Ordinary loss	$([redacted])

9/ This figure included the cost of the land.

10/ The closing was marked by the completion of construction and by the execution of the supplemental lease agreement.

Thus [redacted] claimed a deduction of $[redacted] as an ordinary loss arising out of [redacted]'s sale of the store property to [redacted]. The validity of this deduction is the matter in issue here.

The $[redacted] sales price received by [redacted] for the store property approximated its fair market value. An IRS engineer concluded that the value of the store was $[redacted] as of the date of its opening in [redacted].11/ As for the annual rental of $[redacted] charged [redacted] for the store, it was approximately equal to the fair rental value of the store as of the date the lease between [redacted] and [redacted] was entered into. As of that date (i.e., as of [redacted]), the Government determined that the fair rental value of the store was an annual rent of $[redacted].12/

[redacted] was entitled to all of the condemnation proceeds upon a complete taking of the store. The lease between [redacted] and [redacted] did not grant [redacted] any greater control over the store than that generally held by a tenant.

DISCUSSION

The sale-leaseback in the instant case is not materially distinguishable from the sale-leasebacks in Crowley, Milner & Co. v. Commissioner, 689 F.2d 635 (6th Cir. 1982), aff'g 76 T.C. 1030 (1981), and Leslie Co. v. Commissioner, 539 F.2d 943 (3d Cir. 1976), aff'g 64 T.C. 247 (1975). In those cases, the courts held that losses attributable to construction cost overruns and incurred on the sale part of the sale-leaseback transaction were deductible in the year of the sale.

The facts of Crowley, Milner and Leslie Co. fall within the following hypothetical pattern:13/ A taxpayer corporation desires to construct a building to be used in its business. It locates a site for the building and buys land at the site. It then enters into a sale-leaseback agreement with an insurance company (or other financial institution) whereby the insurance

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11/ [redacted]'s expert determined that the value of the store was $[redacted].

12/ [redacted]'s expert determined that the store had an annual fair rental value of $[redacted] as of the date it opened.

13/ The hypothetical pattern is illustrative of the facts of Crowley, Milner and Leslie Co.. While the facts of the pattern are not identical with the facts of Crowley, Milner and Leslie Co., there are no material differences.

company agrees to purchase the building and land as soon as construction of the building is completed. The insurance company also agrees to immediately lease the property back to the taxpayer corporation for use in its business. The sale-leaseback agreement specifies that the purchase price for the property will be the lesser of (a) $5 million, which is the amount the insurance company estimates will be the value of the property once the building is completed, or (b) the aggregate of the costs incurred by the taxpayer corporation in constructing the building and purchasing the land.14/ The sale-leaseback agreement also specifies that the leaseback will be for a term of 30 years with the taxpayer corporation having two options to renew of 10 years each. The agreement provides that annual rent during the 30-year term of the leaseback will be $450,000 and that annual rent during both 10-year renewal periods will be $475,000.

The taxpayer corporation proceeds with construction of the building. It takes 12 months to construct. Due to a variety of factors, construction costs (including the cost of the land) exceed the maximum $5 million purchase price by $500,000. Construction costs, in other words, total $5,500,000. This figure is what the taxpayer corporation adopts as its basis in the building property.

Once the building is completed, the sale-leaseback is closed. At the closing, the taxpayer corporation conveys legal title to the building property to the insurance company in exchange for $5 million cash. Contemporaneously with this conveyance, the insurance company and taxpayer corporation enter into a lease which provides for the leaseback of the property to the taxpayer corporation under terms which are identical to the terms specified earlier in the sale-leaseback agreement.

The $5 million received by the taxpayer corporation for the building property approximates its fair market value. The annual rent of $450,000 payable under the lease is approximately equal to the fair rental value of the property. The lease provides that the insurance company would be entitled to all condemnation proceeds upon a complete taking of the property. The lease does not grant the taxpayer corporation any greater control over the property than that generally held by a tenant.

14/ The purchase price in Leslie Co. was equal to the lesser of estimated value or cost. The purchase price in Crowley, Milner, however, was fixed at what was apparently estimated value (i.e., at $4,000,000). Estimated value alone was used in Crowley, Milner probably because it was clear at the outset that construction costs would not be lower than estimated value.

On its income tax return for the year the sale-leaseback was closed, the taxpayer corporation claims a deduction of $500,000 as an ordinary loss arising out of the sale of the building property. The deduction is calculated by subtracting the purchase price of the property (i.e., the $5 million cash received on the sale) from $5.5 million, the amount claimed by the taxpayer corporation to be its basis in the property.15/

Deductions of the same type as that described in the preceding paragraph were at issue in Leslie Co. and Crowley, Milner. The Service in both of those cases challenged the deductions on two grounds: It argued that the sale-leaseback consisted of an exchange of a fee simple estate in the new building for a 30-year leasehold in the building and cash. Since this exchange was partly of like-kind property, the Service argued, it was subject to section 1031 of the Code16/ and, hence, the loss incurred on the exchange was not recognizable in the year of the exchange.17/ The Service's second argument was that the loss should be treated as a cost of acquiring the leasehold. The construction cost overruns comprising the loss should be viewed, the Service asserted, as a premium or bonus paid by the taxpayer corporation for the leasehold. While denying a current deduction for the loss, both Service arguments permitted amortization of the loss over the term of the leasehold.18/

The Tax Court in Leslie Co. and Crowley, Milner rejected the Service arguments. It concluded that section 1031 was inapplicable because there was no exchange. The transfer of the building to the insurance company was for cash only, according to

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15/ The $5.5 million figure represents the total construction cost of the property (including the cost of the land).

16/ All section references are to the Internal Revenue Code of 1954 as amended for the period in question and to the regulations thereunder. Section 1.1031(a)-1(c) of the regulations provided that leaseholds with 30 or more years to run were like kind property with real estate.

17/ Section 1031(a) provided that no loss was to be recognized "if property held for productive use in trade or business or for investment ... [was] exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment." Section 1031(c) provided that this nonrecognition rule applied even if cash boot was received along with the like kind property.

18/ The leasehold term was 30 years in both Leslie Co. and Crowley, Milner.

the court, and hence was a sale, not an exchange. This characterization of the transfer was mandated by the regulations: section 1.1002-1(d) defined an exchange as "a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only" (emphasis added). To determine whether the taxpayer corporation received consideration for the building in addition to money, the court focused on the question of whether the leaseback had capital value. If it did have capital value, it would be part of the consideration received by the taxpayer corporation for the building and, hence, the transaction would be an exchange and not a sale.

The court determined that the leaseback had no capital value. It based its determination primarily on two factors: (1) the amount of cash received by the taxpayer corporation for the building (i.e., the purchase price of the building) was approximately equal to its fair market value; and (2) the rental charged the taxpayer corporation under the leaseback was approximately equal to the fair rental value of the building. These factors established, the court held, that the leaseback had no value. As furnishing additional support for this conclusion, the court noted that the leaseback did not grant the taxpayer corporation any greater control over the building than that generally held by a tenant and that the insurance company (i.e., the lessor) would be entitled to all condemnation proceeds upon a complete taking of the building.19/

Since the leaseback had no value, the court held it was not part of the consideration received by the taxpayer corporation for the building. Cash was the sole consideration received for the building; hence, the transaction was a sale (accompanied by a leaseback) and not an exchange. Since it was not an exchange, it was not subject to section 1031. Section 1031 did not apply, the court held, to disallow the loss.

The Tax Court in Leslie Co. and Crowley, Milner also rejected the Service's second argument. That argument was that the loss should be treated as a cost of acquiring the leasehold and should be amortized over its term. The construction cost overruns comprising the loss were in substance, the Service argued, a payment by the taxpayer corporation of a premium or bonus for the leasehold. Not so, the court held. The

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19/ Both of these additional supporting factors were cited by the Tax Court in Crowley, Milner. In Leslie Co., the Tax Court noted that the insurance company was entitled to all condemnation proceeds but made no mention of the other factor, i.e., of the taxpayer corporation's control over the building under the leaseback.

construction cost overruns were precisely what they purported to be: they were costs incurred to complete the building. Completion of the building was a prerequisite to a sale of the building to the insurance company. The taxpayer corporation incurred the construction cost overruns to ensure that a sale would take place;20/ it did not incur them to acquire the leasehold. The leasehold, the court noted, had no value; hence, the taxpayer corporation can not be presumed to have paid anything for it. The loss at issue was attributable to the construction of the building and was incurred on its sale; it was not attributable, the court held, to acquiring the leasehold.

The Tax Court's rejection of both Service arguments was upheld by the Third Circuit in Leslie Co.. The Third Circuit concluded that section 1031 was inapplicable because there was a sale and not an exchange; it also concluded that the loss should not be treated as a cost of acquiring the leasehold but rather should be treated as a loss incurred on the sale of the building. The reasons given by the Third Circuit for these conclusions were essentially the same as those advanced by the Tax Court.

In Crowley, Milner, the Tax Court's rejection of the Service's section 1031 argument was not appealed.21/ Only the rejection of the other argument was appealed. The Sixth Circuit in Crowley, Milner upheld the Tax Court's holding that the loss should not be treated as a cost of acquiring the leasehold but should be treated as a loss incurred on the sale of the building. The Sixth Circuit found that the construction cost overruns comprising the loss did not represent a premium paid for the leasehold: "Taxpayer did not willingly pay $336,456.48 [the overruns] as a premium to secure a leasehold which had no value greater than the rental value taxpayer was already paying."22/ Since the leasehold had no value, the taxpayer corporation could not be presumed to have paid anything for it. The entire loss was deductible, the Sixth Circuit held, in the year of the sale.

20/ The sale was necessary as a means of financing the building; it enabled the taxpayer corporation to recoup its investment in the construction costs of the building.

21/ The Department of Justice thought the argument was too weak to appeal. In the view of the Tax Division of the Department, "a transfer of property in return for cash equal to the fair market value of such property plus an agreement to lease back the property at its fair rental value resembles a sale much more than it does an exchange of properties" (p.3 of Memorandum For The Solicitor General).

22/ 689 F.2d at 637.

In addition to being rejected by the Tax Court and the Third Circuit, the Service's section 1031 argument was rejected by the Second Circuit in Jordan Marsh Co. v. Commissioner.23/ In that case, the taxpayer corporation sold a department store which it had owned and operated for many years. The buyer paid $2,300,000 in cash for the store. The amount paid equalled the fair market value of the store. Contemporaneously with the sale, the buyer leased the store back to the taxpayer corporation for a term of 30 years and 3 days.24/ The rent to be paid under the lease was "full and normal" rent, i.e., was equal to the fair rental value of the department store. The taxpayer corporation claimed a deduction for a loss on the sale since its basis in the store exceeded the cash received on the sale. The Service disallowed the deduction, asserting that the transaction was an exchange of like kind property which was subject to section 112(b)(1) of the 1939 Code, the predecessor of section 1031.

The Second Circuit held that the transaction was a sale and not an exchange and, hence, was not subject to section 112(b)(1). The court noted that the taxpayer corporation's "capital invested in the real estate involved had been completely liquidated for cash to an amount fully equal to the value of the fee".25/ This indicated, the court held, that the transaction was a sale. The transaction did more than effect a change in the form of ownership, it effected a change in the quantum of ownership whereby the taxpayer corporation "closed out a losing venture".26/ As an additional factor establishing that the transaction was a sale, the court noted that the leaseback had no capital value since the rent charged under it was equal to the fair rental value of the department store. Since the transaction was a sale, the taxpayer corporation was entitled to deduct its loss, the court held, in the year of sale.27/

23/ 269 F.2d 453 (2d Cir. 1959).

24/ There was a renewal option for an additional 30 years.

25/ 269 F.2d at 456.

26/ Id. The taxpayer corporation replaced its investment in the department store with cash.

27/ In Rev. Rul. 60-43, 1960-1 C.B. 687, the Service announced it would not follow the Second Circuit's decision in Jordan Marsh. According to the ruling, "[i]t is the position of the Service that a sale and leaseback under the circumstances ... present [in Jordan Marsh] constitute, in substance, a simple integrated transaction under which there is an 'exchange' of (continued...)

At least one case has held that a sale-leaseback was an exchange and not a sale accompanied by a leaseback. That case was Century Electric Co. v. Commissioner.28/ There the taxpayer corporation "sold" a foundry building for an amount of cash ($150,000) which was substantially less than the fair market value of the building ($205,000 to $250,000). Additionally, under the terms of the leaseback, the taxpayer corporation, as lessee, was not required to pay state and local taxes on the building since the buyer-lessor was exempt from such taxes.29/ These factors established that the leaseback had capital value and hence was part of the consideration received by the taxpayer corporation for the foundry. Since the leaseback was part of the consideration, the transaction was not a sale (for cash only) but was an exchange.

The factors warranting this conclusion in Century Electric were not present in the other cases discussed heretofore. Hence, Century Electric is distinguishable from those cases. It is also distinguishable from the instant case in that the Century Electric factors are not present in it either.

The sale-leaseback in the instant case is not materially distinguishable from the sale-leasebacks in Leslie Co., Crowley, Milner and Jordan Marsh.30/ Those cases establish that a loss

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27/(...continued)
property of like kind with cash as boot."

We have been informed by the Corporation Tax Division that Rev. Rul. 60-43 no longer reflects Service position. Current Service position is that Jordan Marsh will be followed where the sale-leaseback is between unrelated parties. A revenue ruling project to modify or revoke Rev. Rul. 60-43 and to reflect current Service position is under way.

28/ 192 F.2d 155 (8th Cir. 1951), aff'g 15 T.C. 581 (1950).

29/ The buyer-lessor was a college.

30/ It can be argued on the basis of the facts in the instant case that [redacted] sold the store property to [redacted] at the beginning of construction and that thereafter [redacted] acted as the agent of [redacted] in constructing the store. This argument receives support from the facts that legal title to the property passed to [redacted] in [redacted], [redacted] provided interim construction financing to [redacted] and [redacted] was to "reimburse" [redacted] for its construction costs. Even assuming, however, that this argument
(continued...)

incurred on the sale part of a sale-leaseback transaction is deductible in the year of sale provided (1) the amount of cash received for the property sold is approximately equal to its fair market value and (2) the rent charged under the leaseback is approximately equal to the fair rental value of the property. Both of these factors are present in the instant case: [redacted] paid [redacted] $[redacted] in cash for the department store; this sum approximated the fair market value of the store. The annual rent charged [redacted] for the store, $[redacted], was approximately equal to the fair rental value of the store. Thus, based on the <u>Leslie Co.</u>, <u>Crowley, Milner</u> and <u>Jordan Marsh</u> line of cases, [redacted] is entitled to claim a deduction of $[redacted] as an ordinary loss arising out of [redacted]'s sale of the store to [redacted].

This conclusion is buttressed by two additional supporting factors: (1) the leaseback did not grant [redacted] any greater control over the property than that generally held by a tenant and (2) under the terms of the leaseback, [redacted] was entitled to all condemnation proceeds upon a complete taking of the store. Factors of this same type were noted by the Tax Court in <u>Leslie Co.</u> and <u>Crowley, Milner</u> and by the Third Circuit in <u>Leslie Co.</u> as furnishing additional support for their conclusion that the leaseback had no capital value and hence that the transaction was a sale.

In sum, the case law establishes that [redacted] is entitled to claim a deduction of $[redacted] as an ordinary loss arising out of [redacted]'s sale of the store to [redacted].

<u>CONCLUSION</u>

The sale-leaseback transaction between [redacted] and [redacted] Plains should be treated as a sale accompanied by a leaseback. It should not be treated as an exchange. The $[redacted] in construction cost overruns incurred by [redacted] should not be treated as a premium or bonus paid by [redacted] for the leaseback; rather the overruns should be attributed to the construction of

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<u>30</u>/(...continued)
is correct, it does not change the overall economics of the transaction. The economics of the transaction were that [redacted] and [redacted] spent $[redacted] to build a store and recouped only $[redacted] of this amount. After construction of the store was completed, [redacted]'s interest in it was that of a lessee, not an owner. The $[redacted] in construction cost overruns in the instant case were economically the same as the construction overruns in <u>Leslie Co.</u> and <u>Crowley, Milner</u> and should be treated the same taxwise.

the department store and should be treated as a loss incurred on its sale. Accordingly, [redacted] is entitled to claim a deduction of $[redacted] as an ordinary loss arising out of [redacted]'s sale of the store to [redacted].

Sincerely yours,

MARLENE GROSS

By: Alfred C Bishop Jr

ALFRED C. BISHOP, JR.
Chief, Branch No. 2
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